

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:CHI:1:POSTF-101301-02

NJKhan

date: August 2, 2002

to: Donald Fields, Team Case Leader, Appeals LMSB Area 3  
Attn: Pete Bandelow, Appeals Officer, Appeals LMSB Specialty Programs

from: Associate Area Counsel (LMSB), Chicago

subject: [REDACTED] and [REDACTED]  
**Taxable Exchange of CFCs**

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

DISCUSSION

This memorandum responds to your request for assistance dated January 3, 2002. You have requested our legal position with respect to dividend adjustments relating to [REDACTED]. The International Examiner's report extensively sets forth the factual presentation of the case. We will not repeat the examiner's factual presentation but rather provide you with detailed legal analysis and our position with respect to the issues set forth below. This memorandum should not be cited as precedent.

We have coordinated the issue of whether the redemption of preferred stock transferred in the reorganization violated the "solely for voting stock" requirement of I.R.C. § 368(a)(1)(B) with the Mergers & Acquisition Technical Advisor Team ("M&A Team"), Lawrence Davidow and Dianne Taylor. Based on the facts below, the M&A Team agreed with the International Examiner that [REDACTED] met the formal requirements of I.R.C. § 368(a)(1)(B) and that the redemption of stock did not violate the "solely for voting stock" requirement of § 368.

With respect to the issue below, we are submitting this advisory opinion for post review and anticipate a 10-day response from the National Office. As you know, the response can supplement, modify and/or reject the advice contained herein. **Accordingly, please take no action on the advice contained herein with respect to the issue below, until such National Office response is received by the undersigned. You will be promptly notified of any exceptions or modifications recommended to the advice contained herein.**

20296

**I. Issue:**

Whether the [REDACTED] exchange of stock by [REDACTED] in its controlled foreign corporations ("CFCs") for redeemable Class [REDACTED] voting preferred stock of [REDACTED] was a non-taxable transaction under I.R.C. §§ 354 and 368(a)(1)(B), or whether the exchange should have been stepped together and characterized as a taxable exchange of the CFCs by [REDACTED] to [REDACTED] pursuant to the step transaction doctrine.<sup>1</sup>

**II. Conclusion:**

The [REDACTED] exchange of stock by [REDACTED] in its CFCs for redeemable Class [REDACTED] voting preferred stock of [REDACTED] should have been stepped together and characterized as a taxable exchange of the CFCs by [REDACTED] to [REDACTED] pursuant to the step transaction doctrine.

**III. Facts**

The following facts are as set forth in the revenue agent's memorandum, supplemented by Forms 886-A and supporting exhibits, and the taxpayer's responses regarding the proposed dividend adjustments.

[REDACTED]  
[REDACTED] or "[REDACTED]"). These services include [REDACTED]  
[REDACTED]  
[REDACTED]<sup>2</sup>

[REDACTED]  
[REDACTED]<sup>3</sup>  
[REDACTED]  
[REDACTED]

[REDACTED] also maintained a [REDACTED] % interest in [REDACTED]  
[REDACTED]  
[REDACTED]

---

<sup>1</sup>In this memorandum, although [REDACTED] is the owner of the CFCs at issue, at certain times reference is made to [REDACTED] as the owner of the [REDACTED] CFCs because [REDACTED] is the wholly-owned subsidiary of [REDACTED] and a member of [REDACTED]'s consolidated group.

<sup>2</sup>[REDACTED]

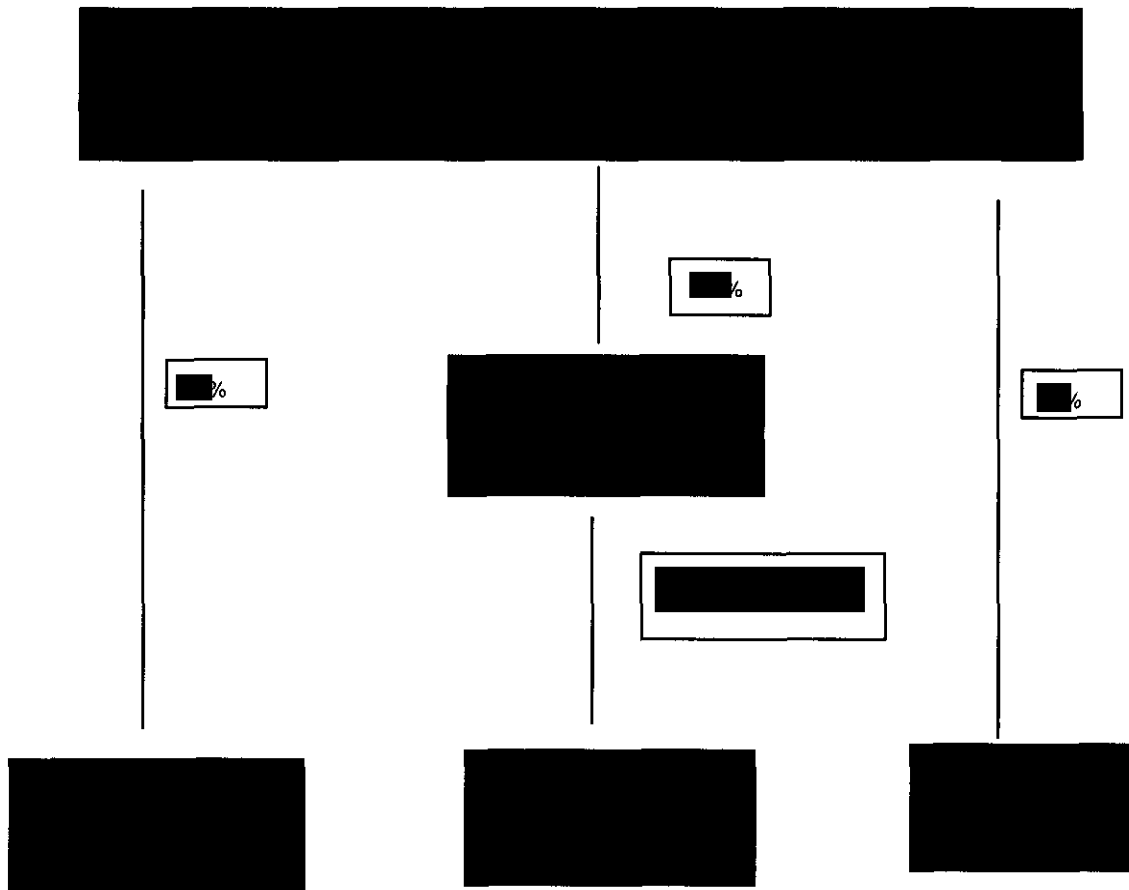
<sup>3</sup>[REDACTED]

<sup>4</sup>[REDACTED]

[REDACTED]

[REDACTED]<sup>5</sup>

Prior to [REDACTED] [REDACTED] had the following ownership interests in [REDACTED] [REDACTED] [REDACTED] and [REDACTED]



As of [REDACTED] [REDACTED] began to expand its business operations to make a future [REDACTED]-based public offering of equity/debt.<sup>6</sup> (See attached Diagram B) Through a series of transactions, [REDACTED] expanded its business operations and enriched itself in the process. [REDACTED] structured these transactions, as follows (See attached Diagram A):

#### Step 1. The [REDACTED]/[REDACTED] Merger

On [REDACTED] [REDACTED] and [REDACTED] entered into a Merger Agreement which allowed [REDACTED] to increase its ownership in [REDACTED] from [REDACTED]% to [REDACTED]% through an exchange

<sup>5</sup> [REDACTED]

<sup>6</sup> [REDACTED]

of stock.<sup>7</sup> The deal was closed on [REDACTED]. The [REDACTED] Merger also included the following ancillary agreements:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

These ancillary agreements, discussed above, were conditioned on the [REDACTED] Merger and became effective the same date [REDACTED] increased its ownership in [REDACTED] from [REDACTED] % to [REDACTED] % percent.

Schedule [REDACTED] of the "Agreement and Plan of Merger" dated [REDACTED] summarized the terms of the ancillary agreements involving [REDACTED] and [REDACTED] as follows:

[REDACTED]

[REDACTED]

---

<sup>7</sup> [REDACTED]

<sup>8</sup> [REDACTED]

<sup>9</sup> [REDACTED]

In [REDACTED] the boards of directors of [REDACTED] and [REDACTED] established "[REDACTED]" to consider possible exercise of the options acquired under the [REDACTED]. On [REDACTED] those committees met and agreed to hire [REDACTED] to assist in determining the fair market value of [REDACTED]'s foreign operations. Executives of [REDACTED] also attended and announced their selection of [REDACTED] to do the same. Both of these valuation firms had previous relationships with [REDACTED] and [REDACTED].

The [REDACTED] / [REDACTED] Merger allowed [REDACTED] to expand its business operations for a public offering in [REDACTED] by increasing its ownership in [REDACTED] in exchange for an option to acquire an interest in [REDACTED]'s CFCs. Additionally, the [REDACTED] / [REDACTED] Merger Agreement also allowed for [REDACTED] to designate [REDACTED] directors to the Board of Directors of [REDACTED].<sup>10</sup> Approval of the Merger Agreement, constituted the election of such new [REDACTED] designees and a reelection of the current directors of [REDACTED] including an officer and director of [REDACTED]. As a result of the [REDACTED] / [REDACTED] Merger, [REDACTED] increased its ownership interest in [REDACTED] from [REDACTED]% to [REDACTED]%, would immediately have [REDACTED] more [REDACTED] designees as additional Directors of [REDACTED] and would thereafter be able to control the [REDACTED] Board of Directors and the business affairs of [REDACTED].<sup>11</sup>

The [REDACTED] / [REDACTED] Merger was subject to shareholder class action lawsuit. In the lawsuit, shareholders of [REDACTED] alleged that (a) the Merger Consideration was unfair, (b) the Premium offered to [REDACTED] stockholders in the Merger is inadequate for transferring control of [REDACTED] (c) if the Merger is consummated, it is the result of unfair dealing, and (d) the directors of [REDACTED] have breached their fiduciary duties. [REDACTED] and [REDACTED] settled this case. The shareholder allegations cast doubt as to the valuations proposed by [REDACTED] and [REDACTED] valuation firms who had previous relationships with [REDACTED] and [REDACTED]. We are in the process of obtaining more information regarding the lawsuit and the basis for settlement from the archives of the Delaware [REDACTED] Court.

## **Step 2. Transfer of CFCs**

On [REDACTED], [REDACTED] and [REDACTED] entered into an agreement to transfer [REDACTED]'s foreign operations to [REDACTED] as proposed by the [REDACTED]. According to the minutes of the [REDACTED] Board of Directors' Meeting dated [REDACTED], [REDACTED]

<sup>10</sup> [REDACTED]

<sup>11</sup> [REDACTED]

In a letter dated [REDACTED] from [REDACTED]

\*\*\*

2.

[REDACTED]

3.

[REDACTED]

4.

[REDACTED]

5.

[REDACTED]

6.

[REDACTED]

7.

[REDACTED]

- [REDACTED]
- [REDACTED]
- [REDACTED]

8.

[REDACTED]

[REDACTED]

\*\*\*

9.

[REDACTED]

\*\*\*

This letter was initialed by the inspector.

On [REDACTED], the value of the CFCs exchanged by [REDACTED] for the [REDACTED] Preferred stock was \$ [REDACTED].<sup>12</sup> [REDACTED] treated this transaction as a tax-free reorganization under I.R.C. § 368(a) and reported no gain or loss.<sup>13</sup>

On [REDACTED] [REDACTED] [REDACTED]

[REDACTED]

[REDACTED] Further:

[REDACTED]

---

<sup>12</sup>

[REDACTED]

<sup>13</sup>

[REDACTED]

[REDACTED]

With respect to reorganization of [REDACTED] businesses, the memo added: "[REDACTED]

[REDACTED]

[REDACTED]'s memorandum also commented on the proposed exchange procedure, as follows:

[REDACTED]

[REDACTED]

[REDACTED]



[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

---



As of [REDACTED], the parties executed an Exchange Agreement covering the terms for exercise of the [REDACTED] outlined above. The closing was to be the same day. Section [REDACTED] and Schedule [REDACTED] indicated that after the closing [REDACTED] stock would be held as follows:

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
			[REDACTED]
			[REDACTED]
			[REDACTED]
			[REDACTED]
			[REDACTED]
			[REDACTED]
			[REDACTED]

The general ledger for [REDACTED] for the month ended [REDACTED] reflected the following entries:

<u>Account</u>	<u>Description</u>	<u>Amount</u>
[REDACTED]	[REDACTED]	[REDACTED]
	Total [REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
	Total [REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
	Total [REDACTED]	[REDACTED]



**Step 3. The Exchange**

[REDACTED]

[REDACTED]

**Step 4. Transfer of Receivables and Redemption of [REDACTED] stock**

[REDACTED]

<u>Account</u>	<u>Description</u>	<u>Amount</u>
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

[REDACTED]

[REDACTED]

**Step 5. [REDACTED] based public offering**

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

**IV. Discussion:**

The [REDACTED] exchange of stock by [REDACTED] in its CFCs for redeemable preferred Class [REDACTED] shares of [REDACTED] stock should have been stepped together and characterized as a taxable exchange of the CFCs by [REDACTED] to [REDACTED] pursuant to the step transaction doctrine.

I.R.C. § 1248 of the Code taxes gains on the sale or exchange of interests in controlled foreign corporations as ordinary dividend income to the extent of the E&P of

---

15 [REDACTED]

[REDACTED]

the controlled foreign corporations. However, I.R.C. § 354 provides as a general rule that no gain or loss is to be recognized if stock or securities in a corporation which is a party to a reorganization are exchanged pursuant to a plan of reorganization for stock or securities in another corporation also a party to the reorganization. A reorganization is defined in section 368(a)(1)(B) as:

the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

What constitutes control for purposes of section 368(a)(1)(B) is defined in section 368(c) as:

the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

It is a fundamental principle of tax law that the substance of a transaction, and not its form, controls its tax consequences. Under the substance over form and related judicial doctrines, although the form of a transaction may literally comply with the provisions of a Code section, the form will not be given effect where it has no business purpose and operates simply as a device to conceal the true character of a transaction. Gregory v. Helvering, 293 U.S. 465, 469-470 (1935). "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). Conversely, if the substance of the transaction accords with its form, then the form will be upheld and given effect for Federal tax purposes. See Blueberry Land Co. v. Commissioner, 361 F.2d 93, 100-101 (5<sup>th</sup> Cir. 1966), Afg. 42 TC 1137 (1964).

The substance over form and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 TC 770, 783 (1974). The issue of whether any of those doctrines should be applied involves an intense factual inquiry. See Gordon v. Commissioner, 85 T.C. 309, 327 (1985). Given the facts above, it is our opinion that [REDACTED] devised a series of transactions designed to transfer its CFCs to [REDACTED] and increase its ownership in [REDACTED] and [REDACTED] on a tax free basis. Accordingly, [REDACTED]'s transfer of its CFCs to [REDACTED] constitutes a taxable exchange to [REDACTED] under the step transaction doctrine. We now turn to the application of the step transaction doctrine.

#### **A. Step Transaction Doctrine**

On the surface this transaction qualified as a reorganization; [REDACTED] acquired stock in [REDACTED]'s CFCs in exchange for redeemable preferred Class [REDACTED] shares of [REDACTED]

stock. However, within one year of the transaction, ██████ redeemed all the preferred shares. It is our position that the acquisition and subsequent redemption of the ██████ stock by ██████ was part of an overall plan to transfer \$ ██████ back to ██████ and that, therefore, the two events should be considered to be, in substance, one transaction. The consequence of this position would be to treat ██████ as receiving a dividend on the date of the transaction pursuant to Section 1248 of the Code. Alternatively, ██████ asserts that its decision to redeem ██████ stock was based on events that occurred after the transaction and that the transaction and subsequent redemption should therefore be treated as separate transactions.

The resolution of this issue turns on the application of a judicially created doctrine called the step-transaction doctrine. "Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes." Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210, 213-214 (D. C. Cir. 2001), affg. T.C. Memo. 1999-411; see also Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987).

The existence of business purposes and economic effects relating to the individual steps in a complex series of transactions does not preclude application of the step transaction doctrine. True v. United States, 190 F.3d 1165, 1176-1177 (10th Cir. 1999).

To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle. Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine. \* \* \*

Id. at 190 F.3d at 1177.

Under the step-transaction doctrine an analysis is made of the separate steps of a transaction to determine whether each step should be accorded independent legal significance or whether the steps should be treated as related steps in one unified transaction, and "stepped together" to produce the actual result. King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969). This analysis is undertaken in order to determine the substantive realities of a transaction and hence its tax consequences. Gregory v. Helvering, 293 U.S. 465 (1935); King Enterprises, Inc. v. United States, supra.

---

In general, the "incidence of taxation depends upon the substance of a transaction" rather than its mere form. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). A taxpayer has the right to minimize taxes as far as the law allows. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950); Gregory v. Helvering, 293 U.S. 465, 469 (1935). Nonetheless, a taxpayer ordinarily may not through form alone achieve tax advantages which substantively are without the intent of the statute. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). Taxation is not so much concerned with refinements of title as it is with actual command over the property. Corliss v. Bowers, 281 U.S. 376, 378 (1930); Palmer v. Commissioner, 62 T.C. 684, 691-692 (1974), affd. 523 F.2d 1308 (8th Cir. 1975).

The Supreme Court has stated that "A given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). Accordingly, where a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction. See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 654 (5th Cir. 1968); Kuper v. Commissioner, 61 T.C. 624 (1974), affd. in part, revd. in part 533 F.2d 152 (5th Cir. 1976). The essence of the step transaction doctrine is that an "integrated transaction must not be broken into independent steps or, conversely, that the separate steps must be taken together in attaching tax consequences." King Enterprises, Inc. v. United States, 189 Ct. Cl. 466, 474, 418 F.2d 511, 516 (1969).

## **B. Application of the Step Transaction Doctrine**

The step transaction doctrine collapses a series of formally separate steps into a single transaction if the steps are in substance integrated and focused toward a particular result. Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation; namely, (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step (binding commitment test), (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result (end result test), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps (interdependence test). See Penrod v. Commissioner, 88 T.C. at 1428-1430. More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test).

### **1. "Binding Commitment Test"**

Under the "binding commitment" test, a series of transactions is collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987). See Commissioner v. Gordon, 391 U.S. 83, 96 (1968); Ward v. Commissioner, 29 B.T.A. 1251 (1934). The

Seventh Circuit, the court to which an appeal of this case would lie, has concluded that the lack of a binding commitment should be determined only in cases involving multi-year transactions; in other situations, the presence or absence of a binding commitment is simply one factor to be considered. See McDonald's Restaurants v. Commissioner, 688 F.2d 520, 525 (7<sup>th</sup> Cir. 1982); Redding v. Commissioner, 630 F.2d at 1169, 1178 (7<sup>th</sup> Cir. 1980), cert. denied., 450 U.S. 913 (1981).

## **2. End Result Test**

The test most often invoked in connection with the application of the step transaction doctrine is the end result test. Under the "end result" test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result. Penrod v. Commissioner, *supra*; King Enterprises, Inc. v. United States, *supra*. The Seventh Circuit has noted that under the "end result test", the courts will examine the transaction as a whole to see if it was intended to be the 'end result.'" McDonald's Restaurants, 688 F.2d at 524.

## **3. Interdependence Test**

The "interdependence test" examines the various steps in the transaction to determine if they are so interdependent on one another that the completion of one would be fruitless without the completion of all the steps. Paul & Zimet, *Step Transactions*, in *Selected Studies in Federal Taxation* 200, 254 (2d Series 1938), quoted in Redding v. Commissioner, 630 F.2d at 1169, 1177 (7<sup>th</sup> Cir. 1980). Under the "interdependent test", the Seventh Circuit focused primarily on the relationship between the steps, McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520, 524 (7<sup>th</sup> Cir. 1982), and in so doing inquired whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.

### **C. Analysis**

In McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7<sup>th</sup> Cir. 1982), the Court held that what appeared to be a tax-free merger in form was in substance a purchase. McDonald's, the acquiring corporation, exchanged shares of its stock in return for the assets owned by the acquired company. The former shareholders of the acquired company then sold the McDonald's stock six months after the transaction. In reversing the Tax Court decision<sup>16</sup>, the Seventh Circuit held that the merger and subsequent sale of the stock should be "stepped together" and treated as a single transaction. McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520, 525 (7<sup>th</sup> Cir. 1982)

The Court, in McDonalds, also determined that the binding commitment test was not relevant because the entire transaction was completed in six months and took place

---

<sup>16</sup>McDonald's Restaurants of Illinois v. Commissioner, 76 T.C. 972 (1981).



within a single tax year. Similarly, given the facts above, the binding commitment test is also not relevant in this case. Since [REDACTED]'s exchange of stock in its CFCs for the redeemable Class [REDACTED] voting preferred shares of [REDACTED] stock and [REDACTED]'s redemption of the Class [REDACTED] occurred within one year and is not a multi-year transaction, the binding commitment test does not apply. Further, [REDACTED] did not challenge the revenue agent's determination that the binding commitment test was inapplicable.

The Seventh Circuit applied the step transaction doctrine. Under the end-result test, the court noted the history of the relationship between the parties and the determination of the taxpayer to sell the stock. This indicated for the court that the final outcome was intended to be the "end result" of the transaction. With respect to the inter-dependence test, the court concluded that the transaction would not have taken place had taxpayer not been guaranteed the right to sell its newly acquired stock. The court pointed out that the piggyback agreement was very detailed in ensuring that parties would be able to freely transfer its stock.

As for the end result test, the Seventh Circuit focused on the history of the relationship of the parties and the determination of taxpayer to sell the stock exchanged in the transaction. In the instant case, these were related party transactions controlled by [REDACTED] and the facts demonstrate that the end result of the acquisition and redemption of [REDACTED] stock was to transfer funds back to [REDACTED] on a tax-free basis. [REDACTED] structured the transactions and controlled all the parties. [REDACTED] structured the ancillary agreements, discussed above, with [REDACTED] and [REDACTED] that allowed [REDACTED] and [REDACTED] the option to acquire an interest in [REDACTED]'s foreign operations through [REDACTED]. Rather than making an outright taxable sale of the foreign operations to [REDACTED] and [REDACTED] or [REDACTED], [REDACTED] structured the transaction to meet the formal requirements of a reorganization under I.R.C. § 368(a)(1)(B). [REDACTED] transferred its foreign operations to [REDACTED] in exchange for redeemable preferred stock. Next, [REDACTED] and [REDACTED] each exercised their options to acquire a [REDACTED]% ownership interest in [REDACTED]. Within one year of the date of the reorganization transaction, all of the [REDACTED] Class [REDACTED] voting preferred stock exchanged in the reorganization transaction is redeemed.<sup>17</sup> This redemption resulted in \$[REDACTED] being transferred back to [REDACTED].

Further, [REDACTED]

<sup>18</sup> In the same memorandum, [REDACTED]

---

<sup>17</sup> As of [REDACTED], all of the Preferred Class [REDACTED] shares and [REDACTED]% of the Preferred Class [REDACTED] shares had been redeemed and erased from the books of [REDACTED] by simply reversing the [REDACTED] journal entries. The remaining [REDACTED] redeemable Class [REDACTED] Preferred Shares were erased by [REDACTED].

<sup>18</sup> See memorandum from [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] It is our position that the end result test has been met because the acquisition and subsequent redemption of the [REDACTED] stock by [REDACTED] was part of an overall plan to transfer \$ [REDACTED] back to [REDACTED]. Therefore, the two events should be considered to be, in substance, one transaction.

Applying the interdependent test, the Seventh Circuit focused primarily on the relationship between the steps, McDonald's Restaurants, 688 F2d at 524, and in so doing inquired whether 'the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. There is sufficient evidence of interdependence in the internal memorandum from [REDACTED] to [REDACTED] and [REDACTED] and the financial statements of [REDACTED] to answer the question conclusively.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] s acquisition of the [REDACTED] stock through [REDACTED] would have been fruitless without the redemption of those shares. The acquisition of the [REDACTED] stock would not

---

<sup>19</sup>Id.

<sup>20</sup>

[REDACTED]

[REDACTED]

<sup>21</sup>

[REDACTED]

[REDACTED]

have taken place without the planned redemption of those shares of stock. First, █████ controlled all the parties (Step 1, The █████/█████ Merger) and structured the transfer of its CFCs from its wholly-owned domestic subsidiary, █████ in exchange for redeemable preferred stock from its wholly-owned foreign subsidiary, █████ (Step 2, Transfer of CFCs). After █████s CFCs were transferred to █████ and █████ each exercised their options to acquire a █████% ownership interest in █████ (Step 3, The Exchange). One day before the transfer of the CFCs and after █████ and █████ acquired an interest in █████ █████ reveals in an internal memorandum its intention to make a █████ based public offering and to redeem all of the █████ preferred shares either before or after the proposed public offering. █████ months after the reorganization transaction, █████ redeems all of its Class █████ voting preferred stock and █████% of its Class █████ voting preferred stock and transfers \$█████ of receivables back to █████ (Step 4, Transfer of Receivables and Redemption of █████ Stock).<sup>22</sup> As of █████ █████ makes a █████-based public offering (Step 5, █████-based public offering).

Standing alone, none of the individual steps identified above makes any objective sense without the contemplation of the subsequent steps in the transaction. Each step in the transaction leads to the next. The █████ Merger and the ancillary agreements that allowed █████ and █████ interests in █████s CFCs would not have taken place without the guarantee that funds would be transferred to █████ created agreements and devised the structure that allowed its other controlled entities, █████ and █████ to acquire interests in █████s foreign operations. █████ gave both █████ and █████ an option to acquire an interest in its foreign operations. █████ and █████ exercised these options only after the transfer of the CFCs to █████ exchanged redeemable stock for the CFCs. █████ redeemed the stock after █████ and █████ exercised their options. █████ receives \$█████ of receivables. The only practical characterization of the receipt of the receivables is as payment for the transfer of the CFCs' ownership from █████ to █████ Accordingly, it is our position that the interdependence test is also met because the acquisition and redemption of █████ stock were interdependent steps that allowed funds to be transferred back to █████ from the reorganization transaction.

Further, █████ could have achieved the transfer of the CFCs in a tax-free manner without receiving any of the \$█████ in receivables and dividend is eliminated. Since █████ already owned █████% of █████ █████ could have transferred the ownership of the CFCs to █████ in █████ as a I.R.C. § 351 transaction. Clearly, the path chosen by █████ was an attempt to accomplish both the transfer of the CFCs and its own enrichment, without incurring any tax liability with respect to that enrichment.

---

<sup>22</sup>By █████ one year after the reorganization transaction, all of the █████ preferred shares are redeemed.

## **V. [REDACTED]'s Arguments**

With respect to our position that the [REDACTED] exchange of stock by [REDACTED] in its CFCs for redeemable preferred Class [REDACTED] shares of [REDACTED] stock should have been stepped together and characterized as a taxable exchange of the CFCs by [REDACTED] to [REDACTED] pursuant to the step transaction doctrine, [REDACTED] disagrees with the resulting dividend adjustment under section 1248 of the Code for three reasons. First, [REDACTED] claims that the changes recorded in the various capital accounts relating to the preference share redemptions were erroneous and that the [REDACTED] stock was revalued as of [REDACTED] and still outstanding as of [REDACTED]. Second, [REDACTED] argues that the treatment of the preferred shares as debt in [REDACTED]'s valuation for the IPO is irrelevant to the issue. Third, [REDACTED] asserts that the government has not proven the mutual interdependence of the transactions at issue.

In response to [REDACTED]'s first and second arguments, [REDACTED] clearly disagrees with the facts identified from its own accounting records and the inference drawn from the valuation of [REDACTED] it sought prior to the IPO. While [REDACTED] has argued that its own accounting records are erroneous and that no negative inference should be drawn from the valuation reclassification of preferred stock to debt, neither of these arguments is supported by any fact. For instance, why weren't [REDACTED]'s accounting errors discovered and corrected during the valuation process or during any other review, before the adjustments made by the revenue agent? [REDACTED] intended to redeem and actually did redeem the Class [REDACTED] preferred stock issued in the [REDACTED] reorganization. Given the facts above and as illustrated in the [REDACTED], [REDACTED] never intended the [REDACTED] preferred stock to remain outstanding.

[REDACTED] devised the above transactions to allow the transfer of its CFCs from [REDACTED] to [REDACTED] on a tax-free basis. Approximately \$[REDACTED] dollars in proceeds from the transfer was shifted to [REDACTED] without recognizing any gain on the transaction. [REDACTED] also increased its ownership in [REDACTED] and [REDACTED] in exchange for a \$[REDACTED] receivable that was ultimately transferred back to [REDACTED]. These were all related-party transactions structured by [REDACTED] to enrich itself and avoid U.S. taxation. Also, the tax-savings on these transactions improved [REDACTED]'s portfolio for the [REDACTED]-based public offering.

In response to [REDACTED]'s third argument, mutual interdependence must be deduced and concluded from all of the facts and circumstances surrounding the above transactions. It is highly unlikely that any of the structured transactions would have occurred if the remaining transactions in the process, which allowed the transfer of funds to [REDACTED] in a tax-free manner, had not been planned.

[REDACTED]'s alleged reorganization in [REDACTED] fails to qualify as a reorganization under I.R.C. § 368(a)(1)(B) because the evidence shows that [REDACTED] had no intention of retaining the preference shares issued in exchange for the CFCs' surrendered. In fact, as of [REDACTED], all of the Preferred Class [REDACTED] shares and [REDACTED]% of the Preferred Class [REDACTED] shares had been redeemed and erased from the books of [REDACTED] by simply reversing the [REDACTED] journal entries. The remaining [REDACTED] redeemable Class [REDACTED] Preferred Shares were erased by [REDACTED].

Accordingly, [REDACTED] must treat the transaction as an exchange of the CFC ownership for the fair market value of that ownership which, is minimally, the amount determined by [REDACTED]'s own independent accountants. Finally, by virtue of I.R.C. § 1248, the gain from that exchange is treated as dividend income to the extent of the E&P of those CFCs identified above.

[REDACTED] devised a way to enrich itself, change the ownership of its foreign operations, and pay no tax, all at the same time. [REDACTED]'s exchange of [REDACTED]'s stock in its CFCs for redeemable Class [REDACTED] voting preferred shares of [REDACTED] stock should have been stepped together and characterized as a taxable exchange of the CFCs by [REDACTED] to [REDACTED] pursuant to the step transaction doctrine.

In the interim, should you have any questions regarding this memorandum or our recommendations, please contact the undersigned at (312) 886-9225, ext. (b)(6) [REDACTED]

PAMELA V. GIBSON  
Associate Area Counsel(LMSB), Chicago

By: \_\_\_\_\_  
NASEEM J. KHAN  
Attorney